depreciation lives. These factors served to maintain low telephone rates and to accomplish public universal service objectives.

However, the introduction of competition into the local exchange market requires that depreciation lives be adjusted to properly reflect economic lives going forward. Also, as explained below, the future cost of capital will increase. These represent very real costs which Pacific Bell will incur with the onset of competition. There is a need to compensate Pacific Bell for its present unrecovered costs.

Failure to allow recovery of stranded costs will increase the risk of investing in incumbent LECs like Pacific Bell for two reasons. First, the credibility of the Commission will be questioned and cause investors to be wary of future commitments made by the Commission. Second, the financial viability of Pacific Bell and other incumbents will be hindered thereby causing investors to demand a higher return in order to invest. This leads to either an unnecessary increase in the cost of capital or a shortage of investment funds available to the incumbent LECs that the Commission regulates.

It is important to note that in the end consumers must absorb any resulting economic inefficiencies. Such inefficiencies will be manifested in higher prices, poor quality of service, and lack of innovation.

It should be recognized that stranded costs are essentially a form of common cost and should be treated as such. Recouping stranded costs can be considered part of the common costs to which the price of access and interconnection services supplied by Pacific Bell to competitors can appropriately contribute or even cover completely.[45]

An economically appropriate means to recover the costs of stranded investments is a markup on the prices of exchange access services and unbundled network elements. In doing so, incumbent LECs operating in both the local and interLATA markets will be charging competitors the same price for intermediate services which they implicitly charge

[45] Baumol, William J. and J. Gregory Sidak, *Transmission Pricing and Stranded Costs in the Electric Power Industry*, Washington D.C.: The AEI Press, 1995, page 147.

themselves. The primary benefit is that a markup on access services and unbundled network elements is competitively neutral and will promote the competitive process.

VIII. PRICING ACCESS AND UNBUNDLED NETWORK ELEMENTS

Perhaps the most significant issue arising in the NPRM concerns the Commission's prior decision that entrants into the local exchange market need not pay access charges when using unbundled network elements to supply exchange access services.[46] The NPRM implicitly recognizes that unbundled network elements are substitutes for access services.[47] Inexplicably, however, the NPRM refuses to acknowledge that charging considerably less for unbundled network elements than for access services will encourage uneconomic entry.

This refusal violates a fundamental economic principle. Where two goods or services are close substitutes, the difference in price between the two should equal the difference in incremental costs. Violating this principle causes buyers to make incorrect decisions in comparing the value that they place on the two goods or services with the opportunity cost to society of the resources used to produce them.[48]

The danger in keeping unbundled network element prices further below access prices than justified by the incremental cost differential is that IXCs will inefficiently substitute unbundled network elements for access. The more the price differential exceeds the cost differential, the more substitution of unbundled network elements for access will occur, and the greater will be the economic harm. This will not only misallocate scarce economic resources but also deprive Pacific Bell and other incumbent LECs of their opportunity to cover shared and common costs and earn a reasonable profit. As a result,

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[46] NPRM, ¶ 54.

[47] NPRM, ¶ 157.

[48] William Vickrey, "Current Issues in Transportation" in Neil W. Chamberlain (ed.), *Contemporary Economic Issues*, rev. ed., (Homewood, IL: Irwin, 1973), p. 231.

incumbent LECs such as Pacific Bell will have insufficient earnings to maintain existing facilities, expand capacity for growth and invest in new telecommunications technologies.

IX. CONCLUSION

In conclusion, I cannot emphasize enough the importance of relying on the market forces unleashed by the Act to govern access prices. The Act contains prescriptive measures intended to give competitors open access to the local exchange networks of Pacific Bell and other incumbent LECs. These open access standards are working successfully as evidenced by the number of comprehensive interconnections arrangements Pacific Bell has entered into through voluntary negotiation and mandatory arbitration. The Commission should not make pricing flexibility for access services contingent upon satisfying any additional standards, metrics or tests. All that is necessary for granting access pricing flexibility is recognition that these arrangements are in place and being used.

I hereby declare, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

Richard D. Emmerson

Subscribed and sworn to before me this 29th day of January, 1997.

Jay Bennett
Director
Federal Regulatory Relations

1275 Pennsylvania Avenue N.W. Suite 400
Washington D.C. 20004
202 383-6429
Fax 202 347-0320

November 15, 1996

<u>EX PARTE</u>

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1*

Today the attached letter was delivered to Ms. Jane Jackson, Deputy Division Chief of the Competitive Pricing Division, Mr. A. Richard Metzger, Jr., Deputy Bureau Chief of the Common Carrier Bureau and Mr. Jim Schlichting, Chief of the Competitive Pricing Division.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions.

Sincerely,

Attachments

cc: J. Jackson
R. Metzger
J. Schlichting

Jay Bennett

Fax 202 347-0320

PACIFIC TELESIS.
Group-Washington

November 15, 1996

Ms. Jane E. Jackson
Deputy Chief
Competitive Pricing Division
Federal Communication Commission
Room 518
1919 M Street, N.W.
Washington, D.C. 20554

Dear Ms. Jackson:

Attached is an analysis of the Commission's decisions regarding contract carriage prepared by Pacific Telesis.

Pacific Telesis requests that the Commission permit local exchange carriers ("LECs") to offer contract prices for those services that the Commission finds subject to substantial competition in a manner consistent with the attached analysis (Attachment I). Contract carriage is consistent with a 1991 Commission Order adopting rules permitting AT&T to offer contract rates pursuant to streamlined regulation for services subject to substantial competition.[1] Furthermore, the Commission already has solicited comment on this contract carriage proposal for competitive access services, and the proposal is supported by a number of parties who argue that it will increase competition and benefit consumers. (For your convenience, an index and summary of those comments from CC Docket No. 94-1 is included as Attachment II.) Based on this record, the Commission should act promptly to allow LECs to offer services pursuant to individually negotiated contracts.

Pacific believes that the record and developments in the marketplace fully support a Commission decision to issue immediately a Report and Order in CC Docket No. 94-1. In light of the volume of comments filed during the last year in that proceeding, the record is sufficiently current and complete to guide the Commission's decision on contract carriage. Further, passage of the Telecommunications Act of 1996 and the

[1] Contracts are one essential tool for competing in today's telecommunications marketplace. In an October 17, 1996 letter in CC Docket No. 96-61, AT&T indicated that it has entered into approximately 5,600 contract tariffs to date. Letter from Gerard Salemme, AT&T, to Regina M. Keeney, Chief, Common Carrier Bureau, FCC (Oct. 17, 1996).

Commission's 1991 Order have eliminated entry barriers and opened LECs to more exchange access competition than ever before. At a minimum, the Commission should propose in the upcoming NPRM on Access Reform that LECs be permitted to offer contracts when facing substantial competition.

Regardless of the course the Commission elects, the attached analysis provides language that should be helpful in preparing either a Report and Order or a Notice of Proposed Rulemaking.

Thank you for your consideration.

Sincerely,

Kay Bennett

Attachments

cc: Jim Schlichting
A. Richard Metzger, Jr.

CONTRACT CARRIAGE WOULD SUBSTANTIALLY BENEFIT CUSTOMERS IN MANY ACCESS MARKETS

As telecommunications markets transition from monopolies to competition, regulators at both the federal and state levels have increasingly allowed common carriers to negotiate terms and conditions of service with end users. These negotiated arrangements are often memorialized in contracts and then filed with regulatory commissions so that similarly situated customers can request similar terms and conditions for themselves. These arrangements are enormously beneficial to customers by allowing them to obtain tailored offerings to meet their specific service needs. Carriers benefit by gaining the flexibility they need to respond to competition. Contract carriage is the right mechanism to permit local exchange carriers that face increasing competition to respond to competition while regulators retain some regulatory oversight. Although AT&T has been declared a nondominant carrier,[1] and is now subject to mandatory detariffing,[2] contract carriage served as a measured, interim mechanism between traditional regulation and full deregulation. The Commission's use of transitional contract carriage for AT&T is instructional on how the mechanism can work for LECs.

In *Competition in the Interstate Interexchange Marketplace*,[3] the Commission adopted new streamlined regulations under Section 203(a) of the Communications Act (the "Act") that allow AT&T to tariff the interstate long distance services it offers certain business customers.[4] The regulations permitted AT&T to offer services pursuant to individually negotiated contracts. At least fourteen days prior to the effective date of a contract, AT&T had to file a tariff with the Commission, based on the terms of the contract and containing all the information required under Section 203 of the Act. The tariff had to contain, at a minimum: (1) the term of the contract, including any renewal options; (2) a brief description of each of the services provided under the contract; (3) minimum volume commitments for each service; (4) the contract price for each service

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[1] Motion of AT&T Corp. to be Reclassified as a Nondominant Carrier, 11 FCC Rcd 3271 (1995), *recon. pending*.

[2] Policy and Rules Concerning Interstate Interexchange Marketplace, FCC 96-424 (released October 31, 1996).

[3] 6 FCC Rcd 5880, [69 RR 2d 1135] (1991), *recon. granted in part and den. in part*, 10 FCC Rcd 4562, [77 RR 2d 253] (1995) (hereinafter "*Interexchange Order*").

[4] The Commission's discussion of "business services" focused on services in Basket 3 (the large business services basket) under price cap regulation, as well as those services outside of price cap regulation. The Commission's discussion did not include services in Basket 1 (residential and small business service) and Basket 2 (800 services) under price cap regulation. *Interexchange Order*, 6 FCC Rcd at 5880-81, ¶ 5 and n.5.

or services at the volume levels committed to by the customers; (5) a general description of any volume discounts built into the contract rate structure; and (6) a general description of other classifications, practices and regulations affecting the contract rate.[5]

The regulations further required AT&T to make its contracts generally available to similarly situated customers, so that these regulations are consistent with the nondiscrimination provision in Section 202(a) of the Act.[6] The Commission retained authority to review the tariffs before they take effect to determine compliance with the Act and the Commission's rules, and to suspend or reject the tariffs as necessary. After the tariffs took effect, the Commission retained authority to investigate and adjudicate complaints that tariffs are unlawful.[7]

The Commission concluded in the *Interexchange Order* that its decision to streamline regulation of AT&T's business services served the public interest, since the "business services market is substantially competitive."[8] Though it acknowledged that AT&T's stature as "by far the largest interexchange carrier" gave it "certain advantages in the marketplace," that fact did not negate "the significant forces that are driving competition in this market segment."[9] The Commission relied on four factors in determining that there was sufficient competition in the business services market to constrain AT&T's prices.

First, the Commission determined that the business services market was characterized by substantial demand elasticity. According to the Commission, the record indicated that business customers were "informed and sophisticated purchasers of telecommunications services," who had both "the incentive and ability to evaluate the full range of market options available to them."[10] The Commission relied on market surveys and AT&T's own estimate of its market share in reaching its conclusion.

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[5] 47 C.F.R. § 61.55(c) (1995).

[6] *See* MCI Telecommunications Corp. v. FCC, 917 F.2d 30 (D.C. Cir. 1990); Sea-Land Service, Inc. v. ICC, 738 F.2d 1311 (D.C. Cir. 1984).

[7] *Interexchange Order*, 6 FCC Rcd at 5894, ¶ 74.

[8] *Interexchange Order*, 6 FCC Rcd at 5887, ¶ 36. The Commission's conclusions, as well as the findings underlying them, were upheld on reconsideration. *See* 10 FCC Rcd at 4562.

[9] *Interexchange Order*, 6 FCC Rcd at 5887, ¶ 36.

[10] *Id.*, ¶ 37.

Second, the Commission found that the business services market was marked by substantial supply elasticity as well. The two factors that determine supply elasticity -- the ability of existing competitors to acquire significant additional capacity and low entry barriers -- were clearly present in the marketplace. To that end, the Commission noted that MCI and Sprint could immediately absorb as much as fifteen percent of AT&T's business traffic during the day without any expansion of their existing capacity.[11]

Third, the Commission relied on AT&T's pricing of business services under price cap regulation as well as unrefuted evidence that AT&T's market share is substantially lower for business services than it is in other markets. The Commission placed special emphasis on the fact that AT&T's prices remained below the price cap limits set for its business services, as well as the fact that its market share for business services was about 50 percent.[12]

Finally, the Commission took pains to refute contrary arguments that the business services market was not substantially competitive. For example, the Commission dismissed as unpersuasive allegations that AT&T had cost and size advantages over competitors, as well as arguments that there was no competition in rural areas because most business customers were not located there.[13]

It should be noted that the Commission established and implemented these contract carriage regulations in a manner that offers maximum protection to consumers. First, as stated above, the regulations required AT&T to make its contracts generally available to similarly situated customers, thus reducing the risk of discrimination. Though some controversies have arisen, most have involved resellers and not "end user" customers. Though the Commission noted in the *Interexchange Order* that its "long-standing policy barring restrictions on resale applies with full force to contract carriage,"[14] some resellers have complained to the Commission that they have been unable to obtain service pursuant to specific contract tariffs because AT&T refused to fill their orders.

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[11] *Id.* at 5888, ¶ 43.

[12] *Id.* at 5889-90, ¶¶ 50-51. In emphasizing this latter statistic, the Commission noted that market share alone is not necessarily a reliable measure of competition, particularly in markets with high supply and demand elasticities. *Id.*

[13] *Id.* at 5891-92, ¶¶ 59, 61-62.

[14] *Id.* at 5901, ¶ 115.

Some have criticized contract carriage because they fear that, under the filed rate doctrine, AT&T has the ability to modify a tariff unilaterally, even over a customer's objection. The filed rate doctrine holds that in cases where both a contract and a tariff govern a carrier's provision of services to a customer, in the event of a conflict between the two; the tariff controls.[15] Some fear that this doctrine, coupled with Section 203 of the Act, permits a carrier to modify the terms of a contract through a unilateral tariff filing.

A close reading of the law indicates that these fears are unfounded. Well-established tariff law severely constrains the ability of a carrier to modify a tariff over the objections of a customer. Since the 1970s, the Commission has recognized that customers entering into long-term service relationships with a carrier are entitled to the benefits of that relationship, absent special circumstances. Thus, tariff revisions that alter material terms and conditions of a long-term contract will be upheld only if the carrier can demonstrate "substantial cause for change."[16] The "substantial cause" doctrine was imported into the contract carriage arena in the *Interexchange Order*.[17] There, the Commission emphasized the fact that tariff provisions were the result of individual negotiation; thus, if a carrier were permitted to alter a contract unilaterally, the benefits of that negotiated agreement would be diminished.[18] The Commission also stressed that, given the substantial competition in the business services market, it was unlikely AT&T would attempt to modify established tariff provisions.[19] All of these principles are grounded in the prohibition of unreasonable practices by carriers in Section 201(b) of the Act.[20]

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[15] *See* Arkansas Louisiana Gas Co. v. Hall, 453 U.S. 571, 582 (1981); American Broadcasting Companies, Inc. v. FCC, 643 F.2d 818 (D.C. Cir. 1980).

[16] RCA American Communications, Inc., 84 FCC 2d 353, 358 (1980).

[17] 10 FCC Rcd at 4572-4574, ¶¶ 23-25.

[18] *Id.*

[19] *Id.*

[20] There is an argument that the prohibition of unreasonable practices in Section 201(b) of the Act cannot be invoked to limit the rights of a carrier to modify a tariff unilaterally. Although this argument seems attractive at first blush, scrutiny reveals that, in practice, it goes too far. It is well-established that tariff revisions by a carrier can be rejected if the Commission finds that any of the proposed terms are patently unlawful. *See* Maine Public Advocate v. FCC, 828 F.2d 68 (1st Cir. 1987). The Commission also

This analysis should lead the Commission to conclude that LEC contract carriage would benefit consumers and competition in the access market as well. The Commission already has solicited comment on whether LECs should be allowed to offer services pursuant to individually negotiated contracts. Just over one year ago, on September 20, 1995, the Commission issued its Second Further Notice of Proposed Rulemaking[21] in which it requested comment on the question: "Should the Commission allow the...LECs to offer individually negotiated contracts for services subject to streamlined regulation...?"[22]

Numerous parties voiced support for the contract carriage proposal. U S West, for example, argues that "contract carriage should be allowed by the Commission for LEC services subject to streamlined regulation," since "both the LEC and its customers benefit from the increased flexibility of tailoring service offerings for specific needs."[23] Similarly, BellSouth advocates the proposal, calling contract carriage "a significant pro-competitive step" with "multiple benefits."[24] Ameritech notes that "contract carriage would benefit customers by enabling LECs to respond directly and specifically to customer needs,"[25] and Pacific Bell argues for "contract carriage of all services in specific, limited competitive geographical areas, based on objective criteria."[26]

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can suspend and ultimately prevent a tariff from taking effect based on a finding that a term is unlawful as an unreasonable practice under Section 201(b) of the Act. *See* Capital Network Systems, Inc. v. FCC, 28 F.3d 201 (D.C.Cir. 1994). Thus, while one might argue that the mere unilateral filing by a carrier of a revision to a tariff is permitted under Section 203, the revision can nonetheless be rejected as unlawful and prevented from taking effect. The consequences to the customer are the same under either legal theory.

[21] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1; Second Further Notice of Proposed Rulemaking, 11 FCC Rcd 858 (1995).

[22] *Id.* at 926, ¶ 150.

[23] U.S. West Comments at 43.

[24] BellSouth Comments at 56-7.

[25] Ameritech Comments at 40.

[26] Pacific Bell Comments at 42.

Nonetheless other parties, including MCI, Sprint and AT&T, express concern that there is not yet sufficient competition in the access market to permit contract carriage.[27] Sprint argues, for example, that "LECs retain bottleneck control over exchange access facilities, and what competition may exist is minimal."[28] None of these parties, however, explains why contract carriage is not in the public interest.

A careful analysis of the access market reveals that these concerns are unfounded. Indeed, the factors that the Commission relied upon in the *Interexchange Order* as indicia of substantial competition in the business services market are clearly present in the access market in specific geographic areas. Although the geographic areas marked by substantial competition currently are all large metropolitan areas, competition will likely expand to markets in medium and smaller cities in the near future.

Pacific Bell's recent experience reveals substantial competition in California's access markets. There is a growing list of facilities-based service providers which include MFS, TCG, ICG, Time Warner, Cox Enterprises, Linkatel, and Phoenix Fiber Link. First, customers in the access market are to a large degree demand-elastic, and frequently switch telecommunications providers in order to obtain either savings or desired features. For instance, Pacific Bell has recently lost significant traffic volumes to competition because of Pacific Bell's inability to offer contracts for its access services. Pacific Bell's recent losses include half of AT&T's DS3 traffic in San Diego and Sacramento, as well as GTE Mobilenet's Sonet ring in San Diego and its DS1 traffic. Pacific Bell's market share for Hicap Services has declined to 55 percent in both the San Francisco and Los Angeles areas. California is such an attractive market that 68 other companies have been authorized by the California Public Utilities Commission to provide local exchange services. Twenty three additional companies are still awaiting approval. Of those 91 competitive local exchange companies, 48 are offering service using their own facilities. These companies have opened more than 560 new NXX codes (5.6 million new telephone numbers) in areas where Pacific Bell provides service to 90 percent of all their business and residence customers.

In addition, supply elasticity in the access marketplace is high. Pacific Bell has tariffed 119 wire centers for physical collocation in the California market. One hundred sixty six collocation cages have been built in just 71 wire centers. These wire centers carry over 70 percent of all Pacific Bell's switched and special access traffic. In the past six months there has been a 75 percent increase in the number of cross-connects installed

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[27] *See* MCI Comments at 34; Sprint Comments at 25-28; AT&T Comments at 19.

[28] Sprint Comments at 25.

in those wire centers, totaling more than 14,500 DS1s. These cross-connects could easily carry over 65 percent of all of Pacific Bell's switched access traffic. These numbers point to substantial supply elasticity in heavy traffic areas in the market, the very places where contract carriage should first become a reality. What is more, Pacific Bell's average switched access rates are substantially lower than the nationwide average: $0.02 per MOU versus $0.0275 per MOU.

Customers in the access market are well-informed and sophisticated purchasers, with the ability to solicit competitive bids before procuring access services. These customers have both the incentive and the ability to evaluate the full range of market options available to them, and to move rapidly between competitors. Increasingly they are doing so, as Pacific Bell's experiences in the California market indicate. Permitting LECs to offer contract prices for services in such markets is a logical and necessary next step.

For the foregoing reasons, contract carriage should be available to incumbent LECs, in markets where there is substantial competition.

EVIDENCE PROVIDED IN CC DOCKET NO. 94-1 REGARDING CONTRACT BASED TARIFFS

Ameritech	Denying the LECs contract tariffs forces them to compete with one hand tied behind their back. Unfair to LECs and bad for consumers. Distorts the operation of competitive forces resulting in inefficient investment and a suboptimal allocation of societal resources. **(Cmts pp.41-42)** Given the size, sophistication, and resources of LECs' competitors, LECs could not possibly hope to drive and keep their competitors from the marketplace, much less do so without detection. Should permit for streamlined services on 14 days' notice.
AT&T	Would not oppose contract carriage for streamlined services after the Commission finds there to be substantial competition in a relevant market. **(R.Cmts pp.49-51)** RFPs do not qualify under any of the recognized exceptions to the rule requiring geographically-averaged rates through a LEC study area. Would simply allow a LEC to offer a preferential rate to a particular customer. Could result in unreasonable discrimination between customers.
BellSouth	Contract carriage would enable LECs to work with customers to develop specific service applications under contract rates, provided that these rates are made available to other similarly situated customers. A pro-competitive step. **(Cmts pp.55-58)** Contract carriage is a means of satisfying a broad spectrum of needs so that every customer can expect its service requirements will be met. Will stimulate the price and service rivalry that the Commission hopes to engender. Can increase network efficiency and lower costs of providing all services. Same terms and conditions to all similarly situated customers. The marketplace will prevent the LECs from engaging in discriminatory behavior.
Cincinnati Bell	LECs are competitively disadvantaged because they don't have the same flexibility as other providers. This harms competition. **(Cmts p.11)** Must be permitted contract carriage so that competitive advantages do not accrue only to certain providers. Where a business customer receives at least two responses to an RFP, competition exists in that geographic market. **(R.Cmts p.5)**
CompTel	Contract pricing must not be allowed unless all functionally similar services are subject to substantial competition. **(Cmts p.40)**
GSA	Define the competitiveness of contract services by the competition shown for the contracts, not for the constituent services within the contracts. **(Cmts p.16)** Believes there should be additional certifications from the LEC, specifically a statement of the circumstances under which the contract was developed and possibly a certification from the end-use customer that competitively viable offers from other suppliers were solicited and received prior to consummation of the contract with the LEC. Complaint procedures will provide a further safeguard against abuse of these procedures. **(Cmts p.16)**

GTE	Individually negotiated tariffs are important tools that are routinely used by most businesses to meet their customer... ..eds. **(Cmts p.18)** Contracts should be permitted providing: 1) The Customer must have issued a RFP and 2) At least one provider other than the LEC must have responded. **(Cmts p.19)** Proposed contract should be filed on 21 days' notice, provide support to show that rates will cover direct costs, be excluded from price caps and comparable terms to similarly situated customers in that market Contract tariffs prevent the rates in LECs' generally available tariffs from providing price umbrellas for entrants. **(Cmts p.20)** In markets subject to streamlined regulation, contract tariffs should be permitted. LECs will lack market power to maintain unreasonable differences in rates among customers. **(Cmts p.75)** If LECs can't provide contract tariffs, competitors will know the LEC's best bid for any customer and knowing that competitors will have no incentive to bid significantly below that level. **(Cmts p.76)** Want proprietary treatment for LEC or customer information. **(Cmts p.76)** Restricting LECs from contract tariffs unfairly advantages other competitors and could deprive customers of the ability to obtain the lowest-cost, highest quality service available. **(R.Cmts pp. 53-55)** If multiple providers respond to an RFP, clearly there is competition for those services. GSA's proposal is reasonable.
LDDS WorldCom	Unless adequate safeguards are in place, LECs will use any additional pricing flexibility to discriminate. **(Cmts pp. 3** They will under price their rivals and cross-subsidize their own interLATA services. Should require structural separation of the LECs' wholesale and retail operations. Need safeguards to ensure that the retail operation purchases network inputs on the same terms and conditions as its rivals. Must delay consideration of any further pricing flexibility until after access reform, structural separation, and the need for a wholesale network platform have been addressed.
MCI	Contract carriage should be limited to services for which the LECs have substantial competition, and safeguards must be included to prevent the LECs from unreasonably discriminating among its customers. **(Cmts pp. 34-35)** Recommends the Commission defer any further inquiry for at least three years and then see if competition has advanced enough to permit consideration of this flexibility. Contracts must be excluded from price caps to prevent cross subsidization. Rates must exceed the direct costs of the contract service which differ from the direct costs of the generic service that this contract service replaces. Must be tariffed and available to any similarly-situated customer. Granting the LECs additional pricing flexibility could stifle entry and harm consumers of less competitive services. **(R.Cmts pp.8-9)** The LECs haven't even used the pricing flexibility the Commission has given them. The mere existence of an RFP does not mean there are multiple companies capable of meeting the requirements. Nor does it mean the LECs are disabled from responding to the RFP using generally available tariffs.

MFS	LEC pricing flexibility must be premised solely on actual competition. **(Cmts pp.8-9)** Should apply the same standards as it applied to AT&T. Only upon a demonstration of robust competition in the relevant market where competitors have established a substantial presence is substantial deregulation warranted. It is not clear that additional pricing flexibility is needed for fair competition or can be implemented in a non\discriminatory manner
NYNEX	LECs won't be able to cross subsidize because the market will drive prices down. **(Cmts pp.33-34)** No single generalized offering is sufficient in all circumstances. Large customers circulate a RFP for bids for their telecommunications needs. LECs must have this pricing package to retain any share of this market. The Commission should allow the LECs to use individualized tariffs to respond to RFPs in competitive situations. The IXCs offer unfounded arguments based on the potential for discrimination and cross subsidization. **(R.Cmts pp. 17-19)** Prohibition of contract tariffs would impede the development of real competition, market-based pricing, efficiency and consumer benefits. Agrees with GSA's proposal. Will benefit consumers by stimulating true competition thereby expanding customer choices, improving service options, and promoting lower prices. Alleged fears of some of potential discrimination are unfounded as contract tariffs would be generally available to all similarly-situated customers, terms made public and rates for other services would not be adversely affected since contract services would be removed from price caps.
Pacific Bell	As long as contract tariff's rates exceed direct costs there is no threat to competition. **(Cmts pp.12-13)** The Commission has lagged behind most state commissions in recognizing the benefits of contract based tariffs. The California PUC has permitted contract tariffs since 1987. Pacific has spent eight years developing the guidelines the Commission uses. Contracts filed with the California PUC disclose prices, service descriptions, volumes and term. Customer names are proprietary. Pacific also provides network diagram, price floors and ceilings, and other information to the CPUC under seal. Our competitors ability to offer contract based pricing gives them a competitive advantage. The Commission's concern about reviewing individual wire center data is overstated since there would not be a different filing for each wire center. **(Cmts. pp 44-45)** Same price terms and conditions made available to all similarly situated customers. No limits on resale, generally available tariff will continue to be available to all. Subsequent changes in contract prices will not result in increased price cap headroom since these services will be removed from price caps. No more ability to increase prices for generally tariffed services than exists presently. The Problem with geographic averaging is that there's only two choices: Reduce prices everywhere including where they are already too low or not reduce everywhere surrendering low-cost markets to competitors. . **(R.Cmts pp. 6-7)**
Southwestern Bell	The standards for filing established by the Commission should be applied to all service providers. Made available to similarly situated customers under the same terms and conditions. Will bring substantial consumer benefits. LECs will be better able to price closer cost. Offer only in competitive markets subject to streamlined regulation. **(Cmts pp.68-69)** Commission rules must be relaxed. AT&T has used contract tariffs for years. GSA doesn't favor more restrictions. MFS (a LEC competitor) has over 1,300 contract offerings in federal tariffs. **(R. Cmts pp.33-34)**

TCA	Believes the proposal goes too far because competition in the access market has not taken hold to the , hat substantial deregulation is warranted. **(Cmts p.5)** It is not clear that additional pricing flexibility is needed for fair competition or can be implemented in a nondiscriminatory manner.
Time Warner	Individually negotiated contracts have a high potential for abuse. It's difficult for competitors to know if they are eligible to receive the services. Therefore creates large risk of price discrimination and predatory pricing by the LEC. **(Cmts p.60)** One of the most important protections against market abuse is the accessibility by the public and LEC competitors of detailed information regarding such contracts.
TRA	Contract carriage should only be permitted for streamlined LEC services if competitive safeguards are adopted. **(Cmts pp.37-38)** Only for services subject to streamlined regulation and in geographic markets where LECs are subject so substantial competition. Tariffs should be filed on at least 14 days' notice. Additional requirements: 1) Make available to all resellers, 2) Provision orders within a reasonable time, e.g., 30 days, 3) Deposit requirements that are reasonable; 4) Establish reasonable termination provisions; and 5) Require advance customer approval for any material change to term plans. Commission should periodically evaluate the effects of contract carriage on the marketplace.
USTA	LECs should be able to offer services under individual tariffs under baseline regulation without a competitive showing. **(Cmts pp. 26-29)** If contract based services are offered on a common carrier basis, they must be offered to similarly situated c rs under the same terms and conditions. Customers do not receive competitive prices because LECs can't offer contract based tariffs, so competitors price slightly below the LEC's tariffed rate. Introduction of contact based tariffs would rectify this situation. Contract based tariffs provides additional consumer benefits: 1) Can be tailored to specific needs; 2) Because contract based tariffs don't reflect averaged costs, rather specific costs, LECs' rates will be set closer to costs; 3) Knowledge that LECs can effectively bid will encourage other providers to make their best offers. Since the RFP process is competitive, unreasonable discrimination will not be realized, since customers can go elsewhere. (See CC Docket No. 93-36 Order, September 27, 1995.) The average tariff price will serve as an effective cap eliminating the concern of supracompetitive profits and the concern of discrimination. The Commission could also require the LECs to show that at least one other party responded to the RFP to show that the responses truly reflected competition. Contract offerings would be outside of price cap regulation. No downside risk in granting LECs contract based tariffs. No opportunity to create headroom. No risk of discrimination since competition exists. AT&T was permitted to use contract tariffs long before the Commission found the interexchange marketplace to be competitive. **(R.Cmts pp. 24-25)**

US West	Commission should allow contract carriage in response to RFPs in baseline regulation. **(Cmts pp.20-21)** An RFP is a widely used business practice for acquiring goods and services. Additional flexibility would provide a fair and competitive basis for such proposals to be considered on an equal basis. By mandating that agreements be available to similarly situated customers, the Commission has effectively precluded the likelihood of unreasonable preferential pricing. The Commission has reasonably proposed guidelines similar to AT&T. **(Cmts pp.43-44)** Customers will be the ultimate losers if the Commission does not act immediately to allow the LECs to offer competitive responses to other, possibly less efficient, providers.

SEP 16 1994

Decision 94-09-065 September 15, 1994

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers.	I.87-11-033 (Filed November 25, 1987)
And Related Matters.	Application 85-01-034 Application 87-01-002 I.85-03-078 Case 86-11-028 I.87-02-025 Case 87-07-024

(See Appendix A for appearances.)

Although we have followed MCI's lead in focusing on the usefulness of MCI's proposal in deriving the LRIC of the competitive elements of bundled toll services, it may be applied more broadly. In more general terms, for bundled services the LRIC of the competitive components may be estimated by subtracting the LRIC of the monopoly building block from the LRIC of the bundled service.

We had hoped to adopt true cost-based prices and price floors in this proceeding, so that it would be unnecessary to manipulate the basic imputation formula to compensate for a lack of unbundled cost data. Adopting LRIC as the appropriate cost standard to use as we authorize increasing competition is an important step, but we are frustrated in our desire to progress further due to the LECs' failure to perform LRIC studies on an unbundled basis. We will require such studies to be submitted in our OAND proceeding (I.93-04-002, R.93-04-003). In that proceeding, the LECs may propose revised price floors based on unbundled LRICs. For services for which unbundled cost studies are not now available, and only until costs are developed on an unbundled basis, Pacific and GTEC may use the variations of the basic price floor formula we have discussed to demonstrate that proposed tariff or contract prices are above the appropriate price floors.

B. Contracts

Public utility regulation has historically relied on tariffs to describe the terms and conditions of service. Tariffs are publicly available, and their rules, terms, and conditions are uniformly applied to all members of a defined class of customers. This uniform application of tariffs to all customers of a particular class arose in part in reaction to what the originators of public utility regulation perceived as patterns of discrimination and preference by monopoly utilities. In California, the uniform application of tariffs is codified as PU Code § 453(a): "No public utility shall, as to rates, charges, service, facilities, or in any other respect, make or grant any preference or advantage to any corporation or person or subject any corporation or person to any prejudice or disadvantage." (See also PU Code § 453(c).)

While embracing principles of nondiscrimination in rates and services, this Commission has also long recognized that circumstances may justify a utility's providing service to individual customers at other than the tariff rate. (See, e.g., G.O. 96-A, § X; D.87-12-027.) Customers with unusual service characteristics, service options, or bargaining power will frequently negotiate with the utility to obtain a better rate or a more customized service than is offered under the tariff. In recent years, we have adopted procedures to streamline approval of contracts deviating from the tariff when the contracts were responses to emerging competition for what had historically been monopoly services. (See D.87-05-071, 24 CPUC2d 412, 417-420; D.88-03-008, 27 CPUC2d 464; D.92-11-052).

In the area of telecommunications, we have gradually expanded the LECs' authority to enter into contracts. (D.87-12-027; D.88-09-059, 29 CPUC2d 376; D.91-07-010, 40 CPUC2d 675.) In our view, it is appropriate that the LECs should have greater contracting flexibility in competitive areas. Firms compete in part on the basis of their ability to tailor their services to meet the needs of specific customers, and these customer-specific arrangements may also reduce the LECs' cost of serving the customer by eliminating services that the customer does not need but that are part of the tariffed package. And if the tailored price makes some contribution toward the fixed costs of operating the network, the LEC's other customers are better off than they would be if the LEC's competitor won the customer's business.

As we expand competition, it is therefore appropriate to expand the LEC's authority to enter into contracts at other than tariff rates. In this order, we adopt provisions to make it easier for the NRF companies - Pacific and GTEC - to enter into contracts for competitive services. The existing processes for handling contracts by other LECs and IECs are not altered by this decision.

An ability to enter into contracts deviating from the tariff rates raises the question whether such arrangements are unlawful preferences or advantages prohibited by § 453(a). We will return to this question as we address the issues the parties raised about contracting.

1. Services Subject to Contract

Pacific and GTEC assert that the current prohibition against contracts for MTS, WATS, and 800 services must be eliminated to permit them to compete for the intraLATA market. Pacific argues that contracting should be permitted for Category II services and for monopoly services other than those specifically precluded by the modified Phase I settlement (D.88-09-059, 29 CPUC2d 376, 382-391), because a monopoly service may be competitive on a customer-specific basis or its tariffed form may not meet a customer's needs. GTEC goes further and urges the Commission to permit the LECs to contract for all services.[54] DRA recommends that contracting should be allowed only for Category II services.

54 GTEC's witness expressly recommended contracting flexibility for access lines and conceded that IECs should have the same treatment. However, since we do not authorize competition for basic exchange service, we will not consider contract flexibility for basic residential and business access lines.

The Phase I Decision authorized contracts for "appropriate" tariffed services, including vertical services,[55] Centrex and CentraNet services other than the Centrex or CentraNet station loop, and High Speed Digital Private Line service. That list should now be expanded to include all private line, MTS, WATS, and 800 services and all other Category II services as defined in this order, including PBX trunks and Centrex or CentraNet access lines. Contracts will be permitted for all Category II and III LEC services.

Allowing contracts to include Category I services at other than tariff rates could encourage rate and service discrimination in contravention of § 453 of the PU Code. Contracts may include Category I services only if they are priced not lower than the tariff rate. However, certain Category I services may not be included in contracts under any circumstances. We affirm our prior decision not to allow contracting for residential subscriber service, business basic exchange lines, ZUM, local usage, and the access line portion of semipublic telephone service.

2. Contract Price Floors

GTEC and DRA agree that the Commission's adopted cost standards, including the imputation tests for bundled services containing monopoly building blocks, should constitute the price floor for contracts. The appropriate basic cost standard for contracts is the LRIC of providing the service under contract, but the parties suggest that the LRIC could be calculated by either of two methods: statewide average LRIC for the service (which we refer to as the servicewide LRIC) or customer-specific LRIC. Pacific asserts that the price floor for contract services should

55 Vertical services were identified in the Phase I settlement as call waiting, call forwarding, speed calling, call hold, three-way calling, intercom, direct connection, call restriction, and call pickup. (29 CPUC 2d at 385.)

be determined on a customer-specific basis, because a customer may not use a monopoly building block, such as switched access, in every case. Based on their approach to imputation, Pacific and GTEC concur that the contract price should recover at least the LRIC for the total service plus the contribution from any monopoly building block involved in providing the service.

In keeping with our adopted price floors, prices under the LECs' contracts must equal or exceed the LRICs (or DECs if they are lower) of each rate element of the contract services, and prices for contracts involving bundled services which include monopoly building blocks must meet all of our adopted imputation tests. Obviously, the LEC must have filed rate element LRICs before it can file contracts subject to LRIC price floors.

We will allow two exceptions to our price floor rule so that LECs will have an ability to match in a fair way the offerings of competitors. First, in order to compete, particularly for large-volume business customers, Pacific and GTEC may use either servicewide or customer-specific LRICs for setting contract price floors. However, customer-specific LRICs must be calculated on an appropriate uniform per-unit basis (e.g., per-foot, per-line). The LEC must establish per-unit LRICs in a compliance filing setting forth the calculation and cost basis for the unit price. The LEC may then apply the unit price to the appropriate characteristic of the customer (e.g., distance from central office, number of lines) to establish customer-specific LRICs for use in calculating price floors for individual contracts.

Second, LECs may in appropriate circumstances offer an average rate that may be less than some of the LRICs of included rate elements, provided that the average rate exceeds the customer-specific cost developed by applying either the servicewide or the particular customer's pattern of use, or profile, to the LRICs for each rate element.